Microeconomics and Macroeconomics
Lecture Notes

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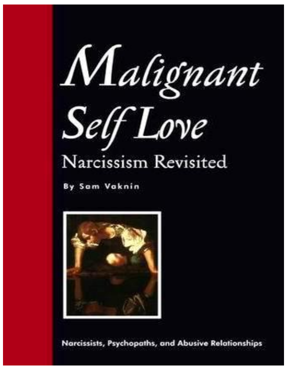

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M o n e y

In the Past / Today

Amber / Coins

Beads / Banknotes

Drums / Checks

Eggs / Credit cards

Feathers / Bonds

Gold / Stocks

Gongs / Derivatives

Ivory / E - money

Jade (I - money)

Kettles / E - securities

Leather

Mats

Nails

Oxen

Pigs

Quartz

Rice

Salt ($=^2$ Salary)

Silver

Vodka

THE BASIC CONCEPTS OF WESTERN ECONOMY

1. Value - Intrinsic and Consensual

2. Exchange or Bartering

3. Scarcity

4. Risk

5. Reward or return (=Yield)

THE FUNCTIONS OF MONEY

Unit of (a)ccounting

Common Measure of value

Medium of exchange

Means of payment

Standard for deferred payment

Store of value

Liquidity

(Framework of) market allocative system (=prices)

Causative factor (in economy and psychology)

Controller (of the economy - e.g., through the money supply)

Money is anything which is widely used for making payments and accounting for debts and credits

THE FUNCTIONS OF THE MODERN BANK

Concepts

The Keynesian (=Investment) multiplier

VS.

The deposit (=Credit) multiplier

The Loan - loss and Deposit - insurance reserves

The Basel Accords and their proposed Amendments

Functions by Categories

Credit Provision

Guarantees (financial / bank, performance)

Deposits (=Demand)

Savings (=Time)

Securities and portfolio management services

Foreign Exchange and Derivatives

Credit cards

Electronic services (informative, operative, home banking, documentary - EDI)

Business development and Investments

Off hour services (e.g., ATMs)

Insurance

Credits - uses

For capital / investment expenditures

Current (working) capital

Imports and capital imports

Exports: raw materials

    working capital

    shipping finance

    documentary discounts (=factoring)

Special groups: students, lawyers, franchisees, etc.

Credits - forms

Overdraft

Fixed and Variable interest

Nominal and Indexed (=linked), optional

Bridge financing

Grace and Balloon loans

Receivables discounts

Leasing - capital, financial, operating, leaseback

Subsidized state credits

Documentary / Incoterms (ICC) / other terms (CMI)

Collect Documentary credits

Small Business

Construction Loans

Consumer loans and mortgages

Third party credits and collection services

SECURITIES AND INVESTMENT PORTFOLIO MANAGEMENT SERVICES

Services and reports to investment portfolio managers

Hedging and Derivatives

Foreign securities

Advisory services

Executory services

Investment Portfolio Management

Mutual Funds (=unit trusts)

Pension, retirement and education funds

Life insurance

Forex and exchange rate hedging

Underwriting

MONEY AND LANGUAGE

Fiji	Whales' Teeth	Tambua	Taboo

England	Cattle	Capital	Capital
	Cattle	Pecus	Pecuniary
Wales	Cattle	Da	Goods
England	Weights	Expendere	Spend, Expenditures, Pound
Greece	Handful	Drachma	Drachma
Ancient World	Weight	Stater	Balancer, Weigher
China	Cowrie Shells	= Money	(Pictograph)
Israel	Weight	Shakal	Shekel
England	Peace	Pacare	Pay
Rome	Salt	Sala	Salary
Italy	Bench, counter	Banca	Bank
Greece	Trapezium - table	Trapezitai	= Bank in Greek

THE ORIGINS OF MONEY

<u>The Story of Moneta</u>

1. Preference of certain items as media of exchange

2. Commodities: conveniently and easily stored

    high value densities

    easily portable

    durable

    widely desired

3. Money developed not only to effect barter:

    to compensate and appease

to pay for brides

to pay taxes and tributes

as religious sacrifice

4. Banking in Mesopotamia: grains were kept in palaces

5. Checks in Egypt: instructions to withdraw grains from the royal warehouses

6. Gold served as today's foreign exchange does

7. Banknotes were first issued in China (=cash)

8. Coins were used to:

maintain standards of purity and weight

to demonstrate political independence

as propaganda and to denote events

9. Fast forms of financing:

money changing (Jesus in Jerusalem)

Bottomry (=carriage of freight by ships)
Mining
Construction

(much latter - 1156 AD): bills of exchange

10. Revolution: counting instead of weighing!

Royal minting and the concept of premium.

11. Another revolution: the symbolization of the money system - banknotes.

INTEREST RATES AND INFLATION

1. Interest rates were meant to compensate for:

The risk of inflation which will erode the money's value

(The Purchasing Power Theory)

The risk of default on the repayment of the credit

The scarcity of the supply of money

2. Today, interest rates are an instrument of monetary policy

3. They are used to:

Control the money supply and the monetary aggregates

Control economic activity

4. Two problems:

Central Banks / the State no longer fully control

The money supply

There is no proven relationship between short - term

Interest rates and any other economic variables

5. Three Paradoxes:

(A) High interest rates = high financing costs = higher prices = higher inflation

(B) High interest rates = higher exchange rate = conversions of larger amounts of foreign exchange + higher prices (of imported products) = higher inflation

(C) High interest rates = difficulty to repay old debts = increasing credit risks = higher interest rates

THE MONEY SUPPLY

M - 1 Currency in circulation

Commercial bank demand deposits

NOW and ATS accounts

Credit Union share drafts

Mutual savings bank demand deposits

Nonbank travellers checks

M - 2 M - 1

Overnight Repos

Overnight Eurodollars

Savings accounts

Time deposits under $100,000

Money markets mutual funds shares

M - 3 M - 2

Time deposits over $100,000

Term repos

L M - 3 and other liquid assets:

Treasury bills

Savings bonds

Commercial paper

Bankers' acceptances

Eurodollar Holdings of US residents

(nonbank)

Documentary Credits and INCOTERMS - International Commercial Terms

1. Part of international sales contracts. Regulate:

(A) Carriage of goods from seller to buyer

(B) Export and import clearances

(C) Division of costs and risks between the parties

2. Electronic Data Interchange (EDI), Electronic Data Interchange for Administration Commerce and Transport (EDIFACT) and Uniform Rules of Conduct for Interchange of Trade Data by Teletransmission (UNCID).

Internet: GE - TPN

3. Electronic Bills of Lading - CMI Uniform Rules.

4. The container revolution and cargo unitization: FCA, CIP and CPT Emphasis shift from means of conveyance to place. Omittance of FOR / FOT / FOBA.

5. Case Study: warehouse to warehouse insurance and the FOB point.

CIF - seller exposed to claims for failing to reach the ships rail on time.

6. The mirror method - the 10 headings.

7. INCOTERMS - part of larger picture (deal with delivery and with nothing after delivery - not with quantity, costs of loading / discharging, clearance, transport, risks of loss / damage and insurance against them, title, quality breach of contract or price). There are: Contract of sale, applicable law, custom of trade.

FOB Buyer would insure - difference between obligation and commonsense.

8. Specific reference required. Example: trading with a US firm (UCC - AFDT).

9. CISG - Contracts for the International Sale of Goods: POD where breach is determined in conjunction w / Incoterms (concerning delivery).

10. D-terms: seller's delivery obligation is extended to the country of destination (arrival contract)

E-terms, F-terms, C-terms: seller fulfils delivery obligation in his country (shipment contract)

11. The common error: there is no connection between risks, costs and delivery.

12. F-terms: <u>F</u>ree of risks

C-terms: <u>C</u>osts borne after critical risk point reached

D-terms: <u>D</u>estination

C-TERMS: 2 points of interest: delivery and risk / costs

13. FCA buyer to instruct seller how to hand over goods - and where

    FCL Full loads (railway wagon / container) vs. LCL break bulk

14. FOB additional service

    Seller contracts for carriage - though he has no obligation to do so

15. FOB The port decides how to distribute loading

16. FAS Seller does <u>not</u> have the obligation to clear goods for exports

    (unlike FOB!)

17. C-terms Do not stipulate arrival date! seller obliged to ship good so that they

    <u>COULD ARRIVE</u>!

18. CFR, CIF Only by sea! A8 demands bill of lading / sea waybill

    If Buyer wants to sell in transit - he will be unable because of lack of the right document Þ breach of seller

19. CIF, CIP Minimum Cover vs. all risk and political

CASH IN ADVANCE / BANK GUARANTEE / CREDIT INSURANCE

Letter of Credit (agreement between 2 banks)

- revocable, irrevocable / confirmed

- conformity (to words in shipping documents)

Sight Draft (=COD) - Document against Payment

- original shipping document attached Þ CB (collecting bank)

- original bill of lading made to the order of the shipper and endorsed by him

- blank
- to order of CB

- notification to drawer of draft about payment

Time Draft

- like sight drafts but paid X days after acceptance

- the CB holds and presents for payment

Open Account

Consignment

Countertrade

Bank Guarantee dependent on underlying obligation or independent (=note)

- Bid bonds - dependent

- Performance bonds - dependent

- Advance Payment bonds - dependent

- Payment Bonds - independent but with recourse and stoppable by court injunction

<u>LOCs</u>

DLC - Documentary

FLC - Financial

SLC - Standby

- CLEAN (Self contained)
- REGULAR (dependent on an event)

<u>Factoring and FORFAIT / EMC</u>

Collection

Credit Protection

Financing (=LOAN / Credit line) on Approved Accounts

Recourse Factoring: Collection + Financing

How to choose a Factor?

<u>Profile of users of Factoring</u>

Restricted access to credit

High or low net worth

Satisfied customers

Credit - worthy customers

Successful products / services

<u>Factoring Services</u>

Conventional Min 2 ½ %, 3 days (5% per 30 day invoice)

weekly agings, daily collection reports

credit services, fees prorated daily,

biweekly reserve releases, 24 hour funding

no hidden fees / long term contracts

Debt Consolidation Payment to creditors when company is in default

Maturity On pre-approved account debtors

Financing / Sale - Leaseback (for bankrupt companies) including equipment

<u>How it works</u>

Bring invoice + delivery slip

Receive upto 80% of the face amount

Receive the balance (reserve) when the invoice is paid

<u>The "Constitution" of International trading - UCP 500</u>

Credit Providers

1. Banks and their changing roles in the West (the virtual bank)
2. Credit card companies through credit schemes
3. Retail chains
4. Investment brokers
5. Mutual Funds
6. Leasing companies
7. Mortgage Banks and other specialized financing institutions
8. International financial organizations and multi-lateral banks
9. Building Societies

<u>An introduction to Western Capital Markets</u>

Hidden Assets of Business Firms:

Refinancing equipment through international leasing

1. Refinancing rental contracts and other property leases
2. Mortgages on real estate

Raising funds from non-banking sources

1. Corporate Bonds
2. Convertible bonds and stocks
3. Derivatives, options and warrants
4. Securitisation of streams of income

ADRs and ADSs: selling shares in the Western capital markets

Venture Capital

1. Seed Money
2. PPO / PPM
3. IPO
4. Exit strategies
5. NASDAQ, EASDAQ, JASDAQ, USM, Vancouver

Small businesses - the Western Experience

Financial Intermediaries - past and present characteristics

<u>Pooling</u> allows large scale borrowing

Diversification allows risky loans

Expertise & expert systems and artificial intelligence

Customization of investment securities (examples: GNMA, CMO, Convertibles, Warrant in bond)

Avoidance of taxes and regulations - Government involvement - insurance (e.g., FDIC) and operations (examples: Eurodollars, Zero coupons, stripping, Dual funds)

Automatisation / computerization

Types of markets

Direct search: sporadic

low priced

non standard

Brokered Services in primary market: search, valuation

Dealer (example: OTC)

Auction (example: NYSE)

Financial Markets - present and future trends

Globalization more communications, less regulation (examples: ADRs, ADSs, Foreign securities)

Securitisation / passthrough (examples: CARs, Bank loans, SLMA)

Credit enhancement insurance - flotation

Bundling and unbundling (examples: Mortgages, Composite securities)

Risk trading

Risk investments / venture capital: seed money

PPO / PPM

IPO

Exit strategies

Risk exchanges

Virtual banking, Finance and Investments

Conditions for the development of capital markets

A healthy, growing economy leading to the growing profitability of firms

The right MICRO- and MACRO-Economic Management

Low real interest rates with high savings rates

Full, timely and accurate information and full disclosure (accounting)

Government involvement

Liquidity

Diversity

Speed and Ease (modern technology)

Fairness, Transparency and Honesty of banks and financial markets

Legislation and law enforcement

Traditional classification of securities markets

Money market (cash equivalents): short term

marketable

liquid

low risk

debt

Capital market long term

risky

diverse

Types of capital markets long term, fixed income

equity

derivative - options

derivative - futures

Money market instruments

T-bills (treasury bills)

Certificates of deposit (CDs)

Commercial paper

Bankers' acceptances

Eurodollars: time deposits

CD

Bonds

Repos and reverses

Federal funds

Brokers' calls

Fixed income (capital market) instruments

Treasury notes and bonds

Federal agency debt FHLB

FNMA

GNMA

FHLMC

(example: financing the farm sector, in the USA):

12 District Bank for cooperatives (seasonal loans)

12 Federal Land Banks (mortgage loans on farm property)

12 Federal Intermediate Credit Banks (short term loans for production and marketing crops & livestock)

Municipal bonds (MUNIS) general obligation (full faith and credit)

revenue

industrial development (private purpose)

tax anticipation notes

Corporate bonds secured

debentures

subordinated debentures

callable

convertible

Mortgage backed securities

EQUITY SECURITIES

Represent ownership / voting rights

Features: residual claim (dividends)

Limited liability

Voluntary ownership

Full, audited disclosure

Shareholders' approval

Democracy and equality

Corporate governance rules

Problems: incompetence / agency

Management pecuniary control / problem

Proxy fights

Corporate takeovers and takeover defences

Dividend yield vs. capital gains (appreciation)

Preferred stock (fixed dividend, no voting, default does not lead to bankruptcy)

- cumulative, dividend exclusion, redeemable, convertible

Price Weighted Average (Index) - ERRONEOUS / (examples) / INDEX FUNDS

Market Value Weighted INDEX I

Equally Weighted Index

Geometric Index

Derivative Assets (contingent claims)

- CALL / PUT Options (=rights) Premium
- FUTURES and FORWARDS (=obligations)

Security trading

Firms float through investment bankers in the primary market.

Trading already issued securities - in the secondary market.

IPOs vs. Seasoned new issues (STOCKS)

Public offering vs. Private placement (BONDS)

Underwriting: lead, syndicate

Red Herring (preliminary prospectus filed with SEC) ® PROSPECTUS

Firm commitment (Investment Bank buy from issuer sell to public), OR

Best efforts

Shelf registration (Rule 415, 1982)

Underpricing and oversubscription

Exchanges and seats, listing criteria

Circuit breakers (the Brady commission)

OTC dealer - broker market: BID and ASK

Third & Fourth Market (INSTINET / POSIT)

National market system

Regulatory agencies: SEC, FED, CFTC, SIPC

National acts and Blue Sky (State) Laws

Insiders trading

Advantages of mutual funds:

Record keeping and administration, diversification & divisibility, professional management, lower transaction costs

AUTHORITIES - KNOW-HOW - FUNDING
DATA - TARGETS - NEEDS

1. **Training**

With workplaces (counters nepotism)

Pyramid approach + minimum time / location commitment

*Assistance: USAID, MBRC, SBA, ISRAEL'S SBA, UNIDO, WB, IFC, ACCOUNTING FIRMS, KHF, EBRD

2. **Small Businesses**

Unemployed voucher communities

One-stop shops

Entrepreneurial skills and specific programs (BP, marketing, financial)

Training (at least, supervision) by international firm / organization

Intrapreneurship (in big firms)

3. **Incubators**

Universities (part ownership)

Big business (partners)

Banks (micro credits) & Securitization in the West

Sharing / OSS

Venture capital, emerging markets funds, intellectual property

4. **Regional Development Planning**

The role of academic institutions

Report evaluation - practical recommendations + implimentation

One-stop shop (revolving door) coomcept

Sector financing in the West

1. *FINANCING INSTITUTIONS / INTERMEDIARIES*

Banks (Glas-Stegall)

SLAs (the 1986/87 crisis)

Pension funds (international diversification)

Investment banks / brokers (blind trust)

2. *TRADITIONAL CLASSIFICATION OF MARKETS*

Money market (=equivalents) short term

marketable

liquid

low risk

debt

Capital market long term

risky

diverse

- Types of (capital markets) long term, fixed income

equity

derivative - options

derivative - futures

Virtual markets E-money

Issues

3. *MONEY MARKET INSTRUMENTS (low risk, high liquidity)*

A. **Government**

3.A.1 T(reasury) Bills

Bank discount yield (BDY) = PAR - P_b / PAR ´ 360 / n

vs. Effective annual yield (EAY) = $(1 + \text{PAR} - P_b / P_b \%)^{366/n}$

B. **Banks / Brokers**

3.B.1 Certificates of deposit (CDs)

Negotiable

FDIC - insured

3.B.2 Eurodollars

Time deposits

CDs

Bonds

3.B.3 Repurchase agreements (REPOS) and reverses

Term REPOS

Overnight interest (the 1985 fraud scandal)

3.B.4 Federal funds LIBOR

Among banks vs. the Federal reserve system

Overnight / at financial statements dates

3.B.5 Brokers' calls

Against O/C (on call) loans

3.B.6 Bankers' acceptances

Used in foreign trade

C. **Corporations**

3.C.1 Commercial paper

Backed by line of credit (LOC)

Upto 270 days (to avoid second registration)

Rollover (the Penn Central 1982 scandal)

4. *FIXED INCOME (Capital Market) Instruments*

A. **Government**

4.A.1 Treasury notes

Upto 10 years

4.A.2 Treasury bonds

Between 10 - 30 years

(Used to be) callable in the last 5 years

Annualized percentage rate (APR) = Bond equivalent yield (BEY) =

PAR - P_b / P_b ´ 365 / n = 365 ´ BDY / 360 - (BDY ´ n)

4.A.3 Federal agencies' debts (no Federal insurance!)

FHLB (securities ® credits to SLAs ® individual mortgages)

FNMA / GNMA

Example: Financing the farm sector:

12 district banks (for seasonal loans to cooperatives)

12 Federal land banks (mortgage loans on farm property)

12 Federal intermediate credit banks

(short term loans for production and marketing)

Example: Mortgage backed securities

Conventional vs. adjustable W/CAPS

Government guarantee

Prepayment option at principal (not at PNV)

B. **Municipalities**

4.B.1 Municipal bonds (MUNIS)

Tax free

Types: General obligation (full faith and credit)

Revenue

Industrial development (private purpose)

Tax anticipation notes

C. **Corporations**

4.C.1 Corporate bonds

Secured

Debentures - Junk

Subordinated debentures

Callable

Convertible

D. **Small Business**

(See separate pages)

E. **Micro Credits**

(See article)

INTERNATIONAL TRADE

1. **Globalization** - economic interdependence of nations.

2. **Imported products** = imported employment = internal unemployment

3. The affair of the **corn laws** (landowners vs. industrialists) in Britain (19th century)

4. **Ricardo's** theory of **Comparative Advantage**

5. **Absolute advantage** - fewer resources to produce same products

Comparative Advantage - it take less to produce the same in terms of other goods

6. **Two country / two goods model - mutual absolute advantages**

Phase A: Mutual absolute advantage

Macedonia USA

Wine 6 2

Tobacco 2 6

<u>Phase B</u>: Land allocation for equal unit production

<u>Macedonia</u> <u>USATotals</u>

Wine 25 x 6 = 150 75 x 2 = 150 300

Tobacco 75 x 2 = 150 25 x 6 = 150 300

<u>Phase C</u>: International trading

<u>Macedonia</u> <u>USATotals</u>

Wine 100 x 6 = 600 0 600 (Mac. sells 300 to USA)

Tobacco 0 100 x 6 = 600 600 (USA sells 300 to Mac.)

7. **Trade** enables countries to **move beyond** previous resource and productivity **constraints**.

8. **<u>Two country / two goods model</u> - unilateral absolute advantages**

<u>Phase A</u>:

<u>Macedonia</u> <u>USA</u> <u>Totals</u>

Wine 50 x 6 = 300 75 x 1 = 75 375

Tobacco 50 x 6 = 300 25 x 3 = 75 375

<u>Phase B</u>: Land allocation for equal unit production

<u>Macedonia</u> <u>USA</u> <u>Totals</u>

Wine 75 x 6 = 450 0 450 (Mac. sells 100 to USA)

Tobacco 25 x 6 = 150 100 x 3 = 300 450 (USA sells 200 to Mac.)

9. **<u>Explanation</u>**: The **opportunity cost** of 3 bales of **tobacco** in **Macedonia** is 3 litres of **wine** **-** in **USA**, only 1 liter.

The **opportunity cost** of 1 litre of **wine** in **Macedonia** is 1 bale of **tobacco** **-** and in the **USA** it is 3 **bales**.

10. When countries **specialize** in production of goods in which they have a **comparative advantage -** they **maximize** their **combined output** and **allocate** their **resources** more **efficiently**.

11. **Terms of trade**: The **ratio** at which a country can trade domestic products for imported ones.

In the above example: 1 litre **wine** = 2 bales **tobacco**

Macedonia benefits because its opportunity cost is 1 = 1

(it would get 1 bale domestically by giving up 1 litre)

USA benefits because its opportunity cost is 1 = 3

(it would have to give up 3 bales domestically to get 1 litre)

12. **Exchange rates** determine the terms of trade.

For any pair of countries, there is a **range of exchange rates** which can lead to both countries **realizing gains from specialization and comparative advantage**.

Within that range, the exchange rate will **determine which country gains the most** from trade.

13. **Two country /two good worlds**

Macedonia USA

Wine 3 DM $ 1

Tobacco 4 DM $ 2

Exchange ratePrice of DMResult

$ 1 = 1 DM $ 1 Macedonia imports both

$ 1 = 2 DM $ 0.5 Macedonia imports wine

$ 1 = 2.1 DM $ 0.48 Macedonia imports wine

$ 1 = 2.9 DM $ 0.34 USA imports tobacco

$ 1 = 3.3 DM $ 0.33 USA imports tobacco

$ 1 = 4 DM $ 0.25 USA imports both

14. **Comparative advantage** can be expressed in **terms of exchange rates**:

Instead of comparing goods directly - money is used.

In Macedonia - the production of 1 bale of tobacco costs 4/3 litres of wine.

15. **Exchanges rates** in the right ranges **drive countries to shift resources** into sectors in which they enjoy **comparative advantages**.

16. **Factor endowments** - the **quantity** of labour, land and natural resources of a country

17. **Heckscher - Ohlin theorem and the Leamer corollary**

A country has a comparative advantage in the production of a product if that country is relatively well endowed with inputs (natural resources, knowledge capital, physical capital, land, skilled and unskilled labour) used intensively in the production of that product.

18. Why countries **import and export the same product?**

Differentiation of products in response to diverse preferences / brand loyalty.

19. **Acquired (versus natural) comparative advantages** (specific skills, goodwill)

PROTECTIONISM

1. **Protection** - shielding a sector of the economy from (foreign) competition

2. **Tariff** - tax on imports

Export subsidy - payment to encourage exports

Dumping - sale of products at prices below the costs of production

Quota - limit on quantity of imports (mandatory and legislated or voluntary and negotiated)

3. **GATT**, the **Uruguay round**, the **WTO**, latest **multilateral WTO agreements**

4. **Free trade zones: EU, NAFTA, MERCOSUR, FTA** (economic integration)

5. **<u>Trade barriers</u>**

Prevent a country from **benefiting from specialization**

Push it do adopt **inefficient production techniques**

Force consumers to pay **higher prices for protected products**

6. **<u>ProtectionCounter - Argument</u>**

(A) **Saves Jobs · Reallocation - not disappearance**

· Retraining **and relocation**

(B) **Unfair trade practices**

Underinvestment in environment

(C) **Cheap foreign labour ·** Reflects **lower productivity**

(unfair competition) · This **IS comparative advantage**

(D) Protect **national security · Every** industry uses it

(E) **Discouraging dependency**

(F) **Safeguarding infant industries · No infant industry asked help**

(allows them to **<u>acquire</u>** comparative advantage)

(H) Protection against · **What is proper rate?**

temporary currency overvaluation

COUNTERTRADE - (A) GENERAL

1. **Countertrade -** a transaction which links exports to imports in place of a financial settlement

2. **Reasons**

(A) Trade financing risky (debt crisis)

(B) Tight import credits (because of low exports)

(C) Entry into new markets (both the exporter and the importer)

(D) Products differentiation and creating competitive advantages

(E) Convertibility or political - financial problems

3. **Transaction phases**

(A) Identify target country arrangements / regulations

(B) Evaluate their attractiveness and

(C) Find the most favoured one from the buyer's perspective

(D) Match your strengths with current / potential countertrade

(internal / external uses for the goods, distribution network)

(E) Consider the accounting / taxation aspects

(F) Choose between in - house expertise and outside specialists

(G) Beware of <u>risks</u>:

(1) Quality and consistency of goods

(2) Delivery times

(3) Supplier reliability

(4) Changes in the value of goods over time

(5) Negative attitude of Governments and IFO's (e.g., EXIM bank in USA)

4. **Countertrade is a marketing tool**:

(A) Generating hard currency for clients

(B) Helping them to market their products

(C) Sharing (information, marketing, technology, production)

5. **Countertrade components**

(A) Piecing together sources of finance, services and supplies in different countries to minimize hard currency net outlays of the importer.

(B) Creating FOREX income for the importer through unrelated protects / new investments.

(C) Partial payment in soft currencies through reinvestment of the proceeds in the importer's country.

(D) Escrow accounts in foreign banks funded by the importer through export revenues (hedge until counterdelivered goods are sold).

6. **Arguments in favour of countertrade**

(A) International commerce - an extension of national (economic) policies.

(B) (Leads to) a preference to deal with trade competition through bilateral accommodations favouring domestic exporters.

(C) Uneven recovery rates and protective import policies.

(D) A hedge against declining trade levels.

(E) The growing third world debts.

(F) Constraints on credits and debt rescheduling.

(G) Dependence of developing countries on import - led growth and export expansion for debt servicing and unemployment.

(H) Tool of long term industrial policy and economic planning.

7. **Factors affecting the future of countertrade**

(A) Ability of world markets to accommodate counterdeliveries.

(B) Nature of assets offered (raw materials, components, finished goods).

(C) Streamlining of bureaucratic bottlenecks.

(D) Willingness of western exporters to engage in higher risk trade.

COUNTERTRADE - (B) FORMS

1. **Countertrade** and offset are reciprocal arrangements.

   Countertrade is the exchange of goods and services intended mainly to alleviate FOREX shortages of importers.

   Offset is intended to advance industrial development objectives.

2. **Assets exchanged** include physical goods, services (e.g., tourism, engineering or transportation), rights (licences, leases, etc.), lien instruments (e.g., sovereign promissory notes), or temporary ownership (BOT - built, operate, transfer arrangements).

3. **Developed industrialized countries** emphasize technology and production processes while **developing countries** emphasize additional exports.

4. The **contractual arrangements** include cashless exchange of goods of comparable value, parallel import / export transactions with their own separate finances, production sharing / equity position.

5. <u>**Countertrade ratio**</u> - percent of the value of export offset by counterdeliveries.

   DISAGGIO - subsidy paid as a commission / discount by the exporter to a broker responsible for marketing counterdeliveries.

   (in the hands of the broker it is **AGGIO**)

   SWITCH - transfer of rights to countertrade goods to third parties.

   Protocol / link or framework contracts - side agreement linking the primary and secondary contracts in a countertrade.

6. **Bilateral Government - To - Government trade agreements -**

   Reciprocal market access privileges (preferential terms):

   (A) To integrate the economies using clearing units - exporters and domestic currency by their Central bank.

   (B) Special political / regional trade relations.

   (C) Trading interests for raw materials sources.

7. **<u>SWING</u>** - margin of credit allowed on a bilateral clearing account (beyond which all trading stops) - usually 30%.

> **Clearing SWITCH -** DISAGGIO driven financial operations. Bilateral imbalances are monetarised by brokerage networks through final sale products sourced from the country with the clearing arrear (or rights to products).

8. **<u>Forms of compensatory trade arrangements</u>**

> **OFFSET -** in cases of purchases of military / (high cost) civilian equipment, counter - purchases are demanded as compensation.
>
> > Usually in the form of expansion of industrial capacity: coproduction, licensed production, subcontracting, overseas investment, technology transfer, countertrade.
>
> **(IN) DIRECT OFFSET** - articles (not) related to the sale.
>
> **BARTER** - one time exchange of goods / services of equivalent value.
>
> > [examples: US - Jamaica, the dissolution of COMECON, Brokers' swaps]
>
> **BUYBACK (Compensation) -** exporter receives products derived from the export.
>
> > Each leg is regulated by a separate contract.
>
> **COUNTERPURCHASE** - exporter receives products unrelated to the export.
>
> > Exporter not allowed to transfer his credits and some advance purchases by exporters qualify.
>
> **UMBRELLA (Coutertrade agreement) -** includes multiple trading partners.
>
> > Between Western exporters and Government entity (**Evidence account**)
> >
> > Between Governments concerning specific products (**Bilateral clearing**)

Countertrade used to release **blocked currencies / funds**

(Expatriation of profits against compensation)

OFFSHORE ESCROW ACCOUNTS - insulation from local banks ensure timely payments to exporters

Allowance for insufficient cash flows (production / marketing slippage)

COUNTERTRADE - (C) ANALYSIS AND PLANNING

1. **BENEFITS (mainly intangible)**

   (A) Locking in foreign market shares

   (B) Circumventing export restrictions

   (C) Supporting subsidiaries /affiliates

   (D) Depleting surplus inventory

   (E) Preserving production / employment levels

2. **COSTS (mainly tangible)**

   (A) General and administrative (handling, documentation)

   (B) Subsidy (DISAGGIO)

   (C) Financing and insurance (including holding & escrow accounts)

   (D) Performance / completion guarantees

3. **RISKS**

   (A) Expensive and partial insurance

   (B) Political risks and bureaucratic delays

   (C) Liability claims (personnel, product)

   (D) Property risks (direct damage or time dependent)

(E) Lack of standardization

(F) Shortfalls in delivery and marketing of the products

(G) Losses due to delays: changes in production / export priorities

sudden unavailability of raw materials

crop failures

inadequate transportation

quality problems

non-competitive pricing

(arbitrary) marketing restrictions

protectionist shifts

contract failures of brokers / end users

4. **COUNTERMEASURES**

(A) Analysis and viable pricing (maybe inflation of export prices)

(B) The right contract

(C) An insurance policy

(D) Information about the importer, the markets and potential competitors

brokers / end users

(E) Recognising **anticipatory purchases** and **additionality** requirements (transferable)

(F) Separate the contracts to insulate performance and

to facilitate financing, guarantees and insurance

5. **The CONTRACTS**

(A) **Primary sale -** standard export contract + countertrade clause

(B) **Link contract -** the countertrade contract includes:

(1) amount and period of obligation

(2) type, standards, pricing criteria of counterdeliveries

(3) names of companies providing counterdeliveries

or: free choice clause.

(4) transferability clause

(5) currency of payments

(6) notification and remittance procedures

(7) rights or restrictions affecting the marketing of goods

(8) non-performance penalties and damages

(9) disputes, termination, unavailability of goods

(C) **Counterpurchase (buyback) contract** includes:

(1) reference to primary contract

(2) standards, specifications, pricing, handling

(3) disputes, force majeure, arbitration, law, indemnities

COUNTERTRADE - (D) SUPPORT SERVICES

1. **TRADING HOUSES have**:

(A) Specialists and experience

(B) Financial resources

(C) Positions in markets and / or marketing networks

Can help with:

(A) Marketing and representation

(B) Transportation, warehousing, insurance

(C) Finance: credits and investment management

(D) Manufacturing, upgrading

2. **BANKS -** advisory services and matchmaking

switch trading of clearing currencies and debt conversions

3. **INSURANCE** - state and private (LLOYDS, CHUBB, AIG)

4. **OTHERS -** law firms, trade consultants and information firms, export management companies, government agencies, industrial giants

INTERNATIONAL TRADE

1. **International trade** is determined by **exchange rates**.

2. **History**: The gold standard, Bretton Woods (1944-1971), the snake (EMS), the Louvre accord (1985).

3. **Influences** on foreign exchange: central banks **interventions**, macroeconomic **policy**, statements by **policymakers**.

4. **Balance of payments**: the record of a country's transactions in goods, services & assets **- current account** and **capital account**.

5. (Merchandise exports - merchandise imports) = **balance of trade** (deficit or surplus) + (exports of services - imports of services) = **net export / import of services** + (income from investments) - (payments to investors) = **net investment income** + **net transfer and other payments** = **current account**

6. Increase (-) or decrease (+) in private (and in Government) **assets abroad** + increase (+) or decrease (-) in foreign private (and in Government) **assets in the country** = **balance of capital account**

7. + **statistical discrepancy** = **balance of payments**

8. **Debtor and creditor nations**

9. The effect of a sustained increase in Government spending (or investment) on income (= the multiplier) - is smaller in an open economy, some of the extra consumption goes to imports.

Multiplier = 1 / 1-(MPC-MPM) (in open economy)

10. Anything that **affects consumption - affect imports** (income, aftertax real wages, aftertax nonlabour income, interest rates, relative prices and the state of the economy).

11. **The trade feedback effect -** export increases consumption which increases imports. Imports in one country is exports in another which increases consumption and so on.

An increase in one country's economic activity leads to worldwide increase in economic activity which feeds back to that country. Its imports stimulate other countries' exports which stimulate those countries' imports and so on.

12. **Prices of exports / imports** are influenced by **inflation**.

Export prices of other countries affect a country's import prices.

Inflation is exported through export. It affects a country's import prices.

13. An increase in the **price of imports** affects **local prices**:

(A) Through **stagflation**: rising prices and falling output

(B) Expensive imports lead to **increased demand for domestic products**

14. **The price feedback effect**

Inflation in one country is **exported** to another and then **re-exported** to the first.

15. **The demand and supply for currencies**

Firms, households and Government that **import / export**

Tourists in / out the country

Buyers of stocks, bonds or other **financial instruments** in / out the country

Investors in / out the country

Speculators who bet with / against a currency

16. What affects **appreciation and depreciation** of currencies?

The law of **one price** (for the same good everywhere)

For the same **basket of goods -** the exchange rate would be determined

by the **relative price levels** in the 2 countries

This is the **purchasing power parity** theory **(PPP)**

17. PPP does not account for **transportation** costs

substitute products are not identical

baskets of goods are different

18. **Relative interest rates -** higher rates lead to appreciation

19. **Imports**, like **taxes** and **savings** are a **leakage** from the income - consumption cycle.

Exports are like **investments** and **Government purchases** (stimulate output).

20. A **depreciation** stimulates **exports** and **domestic consumption** = the **GDP**

21. The **J curve**: balance of trade gets worse before its gets better following a currency depreciation.

Exports increase, imports decrease, currency price of exports doesn't change very much (until domestic prices adjust), currency price of imports increases.

The **value** of imports increases, even as volume decreases, initially.

22. Expansion of money supply, decrease in interest rates, investment and consumption, lower inventories, rising income (output).

Lower demand for debt securities, lower demand for currency, more foreign securities bought, currency sold and depreciates, stimulates the economy.

MACROECONOMY AND THE FINANCIAL SYSTEM

1. J.M. Keynes (1936) - links between money market & goods market

Aggregate demand, output, expenditure

Sticky wages

Activist Government against inflation, unemployment

Policies to manage macroeconomy (fiscal, monetary)

2. Inflation and recessions (1974-5, 1980-2) & **revisionism**:

Policies could have no effect on macroeconomy

3. **Velocity of money** (V) equals GDP / M equals [Y (output, income) times P (price level)] / M

ERGO M times V equals P times Y

4. Quantity theory of money:

V constant V Monetary policy (M) affect GDP

If M doubles GDP doubles - and it cannot change unless M changes

5. V influenced by institutional factors (salaries, processing in banks)

By interest rates

But if so - not constant!

6. <u>Example</u>: Central bank increases M - interest rates fall - demand increases

- more money held per $ income - lower V

7. Empirical data: V not constant

<u>Example</u>: Tiny change in V - huge change in GDP

8. Which money supply measure to use?

The broader - the smoother V is.

9. The time lag between M and its effect on GDP - so maybe V is constant.

10. Government spending financed by money supply (Central bank purchases bonds) induces inflation.

If V and Y constants (Y at its limit) -

P will increase when M increases and **only** if M increases

V becomes constant at a high level.

11. **Monetarists** are against activist Government - it makes the economy less stable because of time lags.

Friedman: M should grow with Y.

12. Arguments between Keynseyans and monetarists

13. **New classical macroeconomics**

The flawed, linear treatment of expectations

People ignore information that would optimise their performance

(this is against rationality in microeconomics)

14. The failure of the Philips curve (inflation - unemployment) ® stagflation

15. **The rational expectations hypothesis** (using true model)

Errors only due to random events - but in true model, they balance out

(true model = all available information)

16. Forecasts have benefits - information has costs.

Irrational not to use cheap information.

17. Prices and wages will be set to ensure equilibrium in all markets.

18. When expectations are rational - disequilibrium only temporary

and a result of a shock

So, Government should never intervene.

19. **Lucas supply function** $Y = fD(P - P^e)$ $P - P^e$ = the price surprise

(A) People / firm specialists in production - generalists in consumption

know more about prices of what they sell

Then about prices of things they buy.

(B) Firms perceive increases in prices of their products more quickly than increase in the general price level (same with workers - wages).

They increase output.

(C) If expectations regarding prices are on target - output will not be influenced by price level.

20. Anticipated policy changes have no effect on real output - no price surprise.

21. Governments must surprise people to affect the economy.

22. Are expectations rational?

    If not - there would have been arbitrage opportunities.

23. But it requires households and firms to know too much.

    Costs of learning true models outweigh the benefits (=profit opportunities).

24. **Supply side economics**

    Supply changes as function of aggregate expenditure (linked to Aggregate demand).

    Fiscal policy affects Aggregate Expenditures through taxation and Government spending.

    Monetary policy influences investments and consumption through changes in interest rates.

    Both are demand oriented (supply reacts passively)

25. High rates of taxation and heavy regulation -

    reduces incentives to work, save and invest

Supply stimulus is needed leads to more labour, more capital, more goods leads to lower unemployment and inflation

26. The Laffer curve - lower tax rates, bigger tax bases

27. **Criticisms**

(A) Tax cuts will not increase labour supply (even reduce it = substitution effect)

(B) Negative elasticity of savings

(C) Tax cuts lead to increased demand and Aggregate Expenditure.

28. **Economic growth -** increase in total output in an economy.

Modern economic growth - began with the industrial revolution.

29. Economic growth expands the production possibilities frontier (PPF).

30. Industrial revolution in agriculture and in textiles.

31. Technological innovation frees resources which encourages growth.

32. Growth occurs when society acquires more resources or increases efficiently of using current ones.

33. Growth - an increase in **real** GDP **per capita**.

34. **Aggregate production function -** the relationship between inputs and output.

35. GDP can increase through

(A) increase in labour

(B) increase in (physical / human) capital

(C) increase in productivity / efficiency

36. **Diminishing returns -** increase in labour with fixed capital:

The new labour will be less productive [Malthus]

37. Malthus neglected technological change and capital accumulation.

38. In an expanding economy (new capital stock) - new labour does not displace old labour

39. **Capital stock** provides services directly enhances the productivity of labour

40. In modern economies capital expands quicker than labour.

41. The importance of human capital

42. **What affects productivity?**

    (A) Technological change (invention leading to innovation)

    (B) Other know-how (invention JIT, management fads, accounting, data, etc.)

    (C) Economies of scale

    (D) Other factors (e.g.: pollution & safety standards, weather, strikes)

43. **Public policies and economic growth**

    (A) To improve the quality of education

    (B) To increase the savings rate

    (C) To encourage RND

    (D) To reduce regulation

    (E) Industrial policy (allocation of capital across manufacturing sectors)

    (F) Growth policy

44. **Arguments pro growth**

    (A) Satisfaction of more needs and wants (progress)

    (B) Improvement in the quality of life

    (C) More choice of products

    (D) Freedom not to do unpleasant things and time savings

    (E) Higher quality

    (F) More jobs, welfare

45**. Arguments anti growth**

(A) Adversely affects the quality of life

(B) Creates artificial needs and enslaves the consumer

(C) Cannot be sustained ® finite resources

(D) Requires unfair distribution of income

1. Why the **inequality** in the distribution of income and what should the Government do about it?

2. The concept of **utility maximization**: if A gets more total utility than B - A is better off than B.

3. The **utility possibilities frontier** - any line inside it is inefficient.

4. **Efficiency & equality**

5. The **efficient point** is determined by **endowments.**

6. But these solutions leave out **non-productive people** (poor).

7. **Taxes** are money transfers to the poor, considered just by the majority.

8. Income and wealth are imperfect - but sole - **measures of utility**.

9. **Income derived from**: Wages and salaries in exchanges for labour

Property (including capital)

Government

10. **Competitive market theory** - All factors of production (including labour) paid a return equal to their marginal revenue products.

11. **Productivity (and income)** vary among types of labour.

12. **Human capital** - stock of knowledge, skills and talents that people possess, inborn or acquired

13. **Compensating differentials** - differences in wages that result from differences in working conditions.

14. **Multiple household incomes** - source of inequality.

15. **Housewiving** exposes the weaknesses of the utility measurement method.

(What is the money utility of a housewife?)

16. **Unemployment** fosters inequality.

17. **Income from property** creates inequality and depends on the quantity and the types of assets.

18. **Wealth** is created through savings and inheritance.

19. **Equity** in owner occupied houses **-** source of inequality.

(by avoiding to pay rent or by receiving rental home)

(through appreciation)

20. **Transfer payments -** made by the Government to people who do not supply goods or services in return.

Reduce the inequality in income distribution.

21. **Economic income -** the amount of money that a household can spend in a given time without increasing/decreasing net assets.

22. **Salaries and wages** are more evenly distributed than total income (including from property).

23. **Lorenz curve -** describes the distribution of income.

Cumulative percentage of families (horizontal axis)

Cumulative percentage of income (vertical axis)

24. The **Gini coefficient -** ratio between shaded area and triangular area below the 45 degree line.

25. **Poverty -** a function of how much it costs to buy necessities of life.

26. Poverty **is relative** - the official **poverty line**: 3 times the cost of the minimum food budget.

27. **Wealth** - accumulation of past generations small businesses become big result of risk taking in a market economy - provides an incentive structure.

28. **Arguments against redistribution**

(A) Market is fair, productivity is rewarded justly

(B) Productive capital yields profits or interest

(C) Freedom of contract and protection of property rights

(Taxation violates these rights)

(D) Interference with the basic market incentives and discourages risk taking

(E) reduction in total output

(F) Sizeable, inefficient bureaucracy

(G) It does not work!

29. **Arguments pro re-distribution**

(A) Moral obligation to provide basic necessities

(B) No fault of children and mentally afflicted, the old and unlucky

(C) Utalitarian justice - marginal utility of income declines with income.

Transfer payments increases total utility.

(D) Social contract theory - rawlsian justice

(E) Marxism

(F) Income distribution as a public good

QUESTIONS

1. Shareholding - What is it?

2. Types of shares

3. Book of shareholders and share certificates

4. Rights of shareholders

5. Guarantees of the rights of shareholders (work?)

6. Share trading limitations (charter, access to book of shareholders, low level of education and information)

7. Voting rights - Proxy

8. New issues of shares

Legal Systems

Common law

Civil law - French

- German

- Scandinavian

11 of 49 countries have one share - one vote system

In Japan no Proxy

1% can call shareholders meeting in USA - 33% in Mexico

1. Conflict between shareholders and management
    - Incompetent
    - Agency problem
    - Proxy fights
2. Democratic management:

    Voluntary ownership

    Disclosure and independent auditing
3. Approval of management decisions by shareholder meetings
4. One share - one vote and proxy for absentees
5. Management subject to control by board of directors

6. Directors chosen by shareholders in meetings

7. Meetings can be called by shareholders and by management.

    One annual meeting mandatory.

8. Closely held corporations

9. Residual claim

    Limited liability

10. Preferred stock - perpetuity (cumulative dividend)

1. **<u>Corporation</u> - Charter** (certificate of incorporation) from state:

    Rights and obligations of shareholders

    Must be **approved by the state**

    Shareholders **amend charter**

2. **<u>Certificate to shareholders</u>** with: **number of shares** on it (registered)

    name, **address**

    holdings in **corporation's books**

3. **<u>Entitled to receive</u>**: **Dividend** payments

    Voting material

    Financial reports

4. **<u>Shares transferable</u>** with help of **issuing corporation**

    or **transfer agents** (banks, trust companies)

5. **<u>Transfer agents</u>** cancel **old** certificates

    and issue **new** ones

    Computerised lists in "records companies"

6. **<u>Registrar</u>** - Registers

Validates

7. **<u>Clearing of transactions</u>**

Certificates **deliverable**, within 5 business days

(unless **cash transaction** or **seller's option transaction**)

8. **<u>Clearinghouses</u>**

Owned by **transfer agents**

Receive **transaction records** daily

Verification for consistency (netting)

Each member receives: List of **net amounts of securities** to be delivered/received + **net money** paid/collected

Daily settlement with clearinghouse

9. **<u>Depository trust company (DTC)</u>**

Computerised lists of **securities "owned"** by members in corporation's books - shares **on DTC's name**.

Internal bookkeeping of share transaction between members

Dividends credited to members accounts - **withdrawn in cash**

10. **<u>Cumulative voting system</u>** or

<u>Majority (straight) voting system</u>

In both: **Number of votes** = number of shares x number of directors to be elected

11. In **MVS** - votes cast per director £ number of shares

(shareholder with 50% + 1 share elects all board)

In **CVS** - votes cast per director £ number of votes

n - minimum of shares

n = + 1 d - numbers of directors shareholder want to elect

s - outstanding shares

D - numbers of directors to be elected

12. CVS allows **minority representation** and is mandatory in some USA states.

13. **The principal - Agent problem -** long term stock options to the management

14. **PAR value -** corporation precluded from paying common stockholders if doing so will reduce balance sheet value of stockholder's equity bellow par value of outstanding stock.

15. **No PAR stock -** stated value instead.

16. **Paid in capital** = D (sale price - PAR value) of share

17. **Common stock** = PAR x numbers of shares

18. **Book value** = retained earnings + common stock + paid in capital

19. To issue **additional stock -** charter must be amended

20. **Treasury stock -** no voting, no dividends

21. **Classified stock -** with respect to dividends and voting

22. **Pre-emptive rights** of first refusal to buy new shares at a discount (rights)

Rights can be sold

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